This argument is circular. Mathematically, the amount of reserve deficiency is determined by assumptions concerning expected life. If, for example, one were to double the prescribed lives of a company's assets and use these revised lives to calculate a reserve deficiency, there would not be a calculated reserve deficiency; in fact, there would be a considerable surplus. Using MCI's argument, rates based on these lengthened lives would be deemed proper since there would be no reserve deficiency. The obvious fallacy of this argument is that it says nothing about the appropriateness of the underlying lives.

MCI presents no analysis indicating whether the prescribed depreciation lives are appropriate. It is interesting to note that MCI's depreciation rate for 1995 was 8.9%, a rate far in excess of the average prescribed LEC composite depreciation rate of 7.3%.[33] In contrast, the LECs have considerable evidence, as detailed by USTA's Reply Comments filed in this proceeding, that indicates the lives currently prescribed for the LECs do not accurately reflect the realities of today's telecommunications marketplace. Although the Commission has not yet accepted the lives being proposed by the LECs, it has shortened lives in the past several years and has allowed an amortization of the existing reserve deficiency. Both actions implicitly recognize that past prescribed depreciation lives were too long. Further support for shorter lives is demonstrated by the fact that those LECs which have come off the FAS71 accounting standard are now using depreciation lives for Securities and Ex-

[33] USTA Reply Comments at Technology Futures, Inc. Attachment, "Implications of Technology Change and Competition on the Depreciation Requirements of the Local Exchange Carriers," at Table 4 ("TFI Attachment").

change Commission reporting that are far shorter than Commission-prescribed lives.

MCI argues that today's prescribed lives should be the basis for a productivity study that they propose should be updated only every four years. This ignores the fact that depreciation lives are being shortened every year, and that under its Simplification Guidelines, even the Commission will allow an update of lives each year.

B&VG argue that "[t]he existing plant need not be replaced (on an accelerated basis) for efficient provision of basic local telephone services. The RBOCs' proposals for accelerated depreciation would compel users of basic telephone services to subsidize new services that many basic customers may not want."[34] This argument ignores the fact that LECs must build integrated telecommunications networks that meet the demands of all classes of customers, including the demands of tomorrow's customers. It is true that there is probably a small group of customers who would be content with rotary dials, cord boards, and multi-party lines, but the vast majority of today's customers have benefited from the advances in technology since the first piece of telecommunications plant was placed in service.

B&VG continue that "[f]urthermore, the FCC's use of remaining life depreciation rates ensures that the large deficits of the early 1980's cannot recur."[35] Reserve deficiencies, in fact, will continue to be created as asset life expectations are

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[34] B&VG Executive Summary at 1.

[35] Id. at 2.

shortened. Utilizing the remaining-life method provides for the recovery of the deficiency over the remaining life of the assets, in essence shifting the burden of past underdepreciation to future generations of ratepayers. B&VG offer an example of how the remaining-life method shifts costs into future periods, which in reality can be ten to twenty years.[36] While this method worked well in the context of a regulated monopoly, this shifting of past costs to the future will prove unworkable in a competitive environment.[37]

B&VG refer to an Oregon study which they say concludes that copper is always the least-cost technology for the distribution loop and, in most cases, for the feeder portion of the subscriber loop as well.[38] It is obvious that the Oregon conclusion was based on "today's" economics, not the economics of the future. Fiber material costs continue to fall, and, as companies move further along the learning curve, installation costs will also decrease. As the outside plant network continues to evolve, with the placement of ever greater amounts of fiber into the feeder and distribution portions of the plant, what is not economical today will become economical tomorrow.

B&VG also argue that local loop reconfiguration does not provide telephony customers with any benefits.[39] This argument ignores the reduced maintenance

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[36] B&VG Study at 7.

[37] Id. at 17.

[38] Id. at 17-18 n.24.

[39] Id. at 18 n.25.

costs and increased reliability fiber will provide in addition to greater bandwidth capability.

B&VG assert that "[g]ranting larger depreciation expense today to finance early retirement of metal and fiber would require basic service customers to subsidize customers of non-basic service."[40] As noted above, there is a real issue as to what basic service is now and what it will be in the future. There is no early retirement. Equipment is retired when it is economically and technologically obsolete. For example, electromagnetic switches could be used to provide a form of basic service, but not the level of service that most of our customers expect today. To be a full-service provider, we must upgrade our network to meet the future demands of customers.

Table 20 of the B&VG study compares data from U S WEST's annual report with "average service life" from U S WEST proposals. This is an "apples and oranges" comparison. The Commission prescribes projection lives, not average service lives. Since U S WEST came off FAS71 in the Fall of 1993, it has proposed the same projection lives for regulatory purposes that it is using for financial reporting purposes.

B&VG argue that depreciation expenses in the past fifteen years were sufficient to correct serious underdepreciation and that current depreciation rates are [redacted] ing basic local services over the useful life of the assets.[41] The study, however, offers no analysis as to what appropriate depreciation lives are. It can therefore offer no basis as to whether there is or is not an underdepreciation issue. The study also offers no analytical evidence as to whether RBOCs can fully recover costs and whether this recovery will actually be in line with the consumption of the companies' assets.

Overall, MCI offers no evidence that today's prescribed depreciation lives and rates accurately reflect the realities of today's telecommunications environment. In assessing what appropriate lives should be, one can look at what the LECs are using for financial reporting purposes. One can also look at the lives that are being prescribed by the Commission for AT&T's plant lives which are for the most part shorter even than the LECs are proposing.[42]

B. The Commission Is Not Required To Select A TFP Based Only On Interstate Input And Should Not Do So

AT&T and Ad Hoc contend that the Commission is required to select a TFP based solely on interstate inputs.[43] This position is neither technically feasible nor legally mandated by prior precedent. In the Fourth FNPRM the Commission determined that interstate and intrastate services are provided largely over common

[41] B&VG Executive Summary at 4.

[42] See USTA Reply Comments, TFI Attachment at Table 3.

[43] AT&T at 14-15; Ad Hoc at 6.

facilities. It further determined that there was no evidence that such facilities could be divided and measured in an economically meaningful manner. The Commission tentatively concluded that TFP should be calculated on a total company basis.[44] Since none of the initial comments to this proceeding presents an approach which would contradict the Commission's earlier findings, the Commission should affirm its tentative conclusion.

As discussed in the Christensen response attached to USTA's Reply Comments in this proceeding,[45] no party has presented a meaningful method for calculating an interstate-only TFP. The proposals presented by AT&T and Ad Hoc suffer from similar infirmities. Both methods attempt to calculate the input growth of interstate services by assuming that inputs grow at the same rate for interstate access service as they do for other regulated telephone services provided by the LECs. As has been previously demonstrated by Christensen,[46] there is no economically meaningful way to partition LEC inputs into separate intrastate and interstate categories. This is true because both services share joint and common inputs. To attempt to calculate productivity for interstate services based on an insupportable assumption necessarily produces results which are arbitrary and capricious.

AT&T further asserts that the Commission is legally required by the Supreme Court's decision in Smith v. Illinois to calculate LEC TFP on an interstate-

[44] Fourth FNPRM ¶ 63.

[45] USTA Reply Comments, Christensen Attachment at 4-7.

[46] Id. at 26-27.

only basis.[47] This assertion is based on an inappropriate expansion of the Court's holding in Smith, wherein the Supreme Court reviewed a district court decision striking down as confiscatory the Chicago coin-box rates as set by the Illinois Commerce Commission. The district court, like the state commission before it, used as a rate base all of Illinois Bell's Chicago property, including both exchange plant and toll lines to the city limits. In computing the revenue generated by that investment, the district court counted both the sums Illinois Bell received directly from local users and the share of interstate tolls AT&T paid for the use of Illinois Bell's long-distance lines in interstate calling.

The Supreme Court reversed the district court's decision. It held that the state commission and the district court erred in not separating out Illinois Bell's intrastate and interstate property, revenue, and expenses. The requisite allocation of property between the interstate and intrastate services, the Court stated, must be made with an eye to "the actual uses to which the property is put."[48] The figures that Illinois Bell had submitted to the district court reflected treatment of the costs of exchange plant as wholly local. That allocation was impermissible, the Court declared, "for unless an apportionment is made, the intrastate service to which the exchange property is allocated will bear an undue burden."[49]

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[47] Smith v. Illinois Bell Telephone Co., 282 U.S. 133 (1930) ("Smith").

[48] Id. at 151.

[49] Id.

As noted previously, AT&T asserts in its comments that Smith is controlling on the Commission in its decision to determine the appropriate company level for the calculation of LEC productivity. To that end, AT&T proclaims Smith as the "landmark decision . . . [which] established the doctrine that the 'separation of interstate and intrastate property, revenues, and expenses of the company . . . is essential to the appropriate recognition of the competent governmental authority in each field of regulation."[50] While Smith may be the landmark decision for the need to perform interstate and intrastate accounting separation, AT&T's use of Smith in the context of this proceeding is inappropriate and well beyond the boundaries of the Supreme Court's holding in Smith.

AT&T attempts to expand the proposition Smith stands for -- that a portion of the costs of local subscriber plant may be recovered only under the authority of a body with interstate regulatory powers -- into its own agenda for the Commission's development of a LEC industry productivity factor. The D.C. Circuit Court of Appeals has previously rejected similar attempts at broadening the decision in Smith which would limit or control the Commission's discretion in establishing specifically tailored regulatory formulas. In MCI v. FCC,[51] the Court reviewed the Commission's choice of cost allocation formulas for telephone equipment used in both interstate and intrastate services. The Court distinguished the holding in Smith from the Commission's discretion in choosing an appropriate cost allocation formula:

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[50] AT&T at 15 citing Smith at 148.

[51] MCI Telecommunications Corp. v. FCC, 750 F.2d 135 (D.C. Cir. 1984) ("MCI v. FCC").

> Furthermore, Smith appears to be based on the limits of state jurisdiction, rather than on constraints imposed on federal agencies by the due process clause. Smith does not constitutionally compel use of a particular formula. Smith compels "only reasonable measures," because the "allocation of costs is not a matter for the slide-rule," but "involves judgment on a myriad of facts." Cost allocation is not purely an economic issue -- it necessarily involves policy choices that are not constitutionally prescribed.[52]

Thus, the Court rejected the attempted use of Smith in limiting the Commission's discretion in its selection of cost allocation formulas.

In a later case before the same Court, Rural Telephone Coalition v. FCC,[53] MCI once again attempted to submit Smith as controlling on the Commission's discretion in devising cost separation formulas. The Court again rejected MCI's argument, stating:

> This is not the first time MCI has attempted to convince this court that Smith requires a particular method of separating costs. Smith holds only that intrastate and interstate telephone costs must be separated for jurisdictional purposes, and that such separation must be done according to "reasonable measures." MCI's construction of Smith unduly emphasizes the Court's requirement of separation at the expense of its admonition that separation must be reasonably made. In the past, we have not interpreted the separation requirement in Smith so strictly. We have held that "Smith does not constitutionally compel use of a particular formula." Smith compels "only reasonable measures."[54]

[52] Id. at 141 (footnotes omitted).

[53] Rural Telephone Coalition v. FCC, 838 F.2d 1307 (D.C. Cir. 1988).

[54] Id. at 1314 (citations omitted).

In its comments to the Fourth FNPRM, AT&T similarly attempts to use Smith to compel the Commission's use of interstate-only data in the calculation of LEC productivity. As Smith applies only to the appropriate allocation of costs between jurisdictions, AT&T's attempt to broaden the Supreme Court's holding to assert that the Commission is required to use interstate-only data in calculating a LEC TFP is legally unsupportable.

C. The Concepts Of Sharing And Low-End Adjustments Are Unnecessary Vestiges Of Rate-Of-Return Regulation

Sharing and low-end adjustments are inappropriate and unnecessary remnants of rate-of-return regulation. The Commission, in the overall development of its price cap methodology, has attempted to give LECs incentives to increase productivity and introduce new services, not simply to pick an arbitrarily determined higher numeric factor. The use of a sharing mechanism, in fact, thwarts this goal for the companies having the greatest difficulty increasing their productivity. Instead of allowing the less productive companies to retain extra revenue achieved beyond the no-sharing level, these revenues which could be used to increase productivity, are returned to the ratepayers, thus inhibiting productivity growth even further. Arbitrarily forcing less productive companies to return revenues to ratepayers in the form of sharing serves only to decrease the productivity growth that could otherwise be achieved.

The low-end adjustment is also inappropriate in a competitive market. Some markets will support only lower rates-of-return. As competition enters the market, competitors cannot be guaranteed prices and returns.

D. Adoption Of The Capped Index Plan Or The TFP Methodology For Productivity Selection Eliminates The Need For A Separate Common Line Formula

Once again, U S WEST reiterates its position, as it did in earlier comments, that the adoption of a Capped Index Plan eliminates the need for a separate Common Line Formula. If a price cap scheme with a productivity adjustment factor is retained, the adoption of the Christensen Simplified TFP method obviates the need for a separate Common Line Formula since growth in access lines and minutes of use is already reflected in the TFP calculation. No credible rationale has been advanced for changing the current formulas to a per-line formula or any other formula.

E. No Changes Should Be Made In Existing Exogenous Cost Rules

In its Fourth FNPRM, the Commission asks if it is "feasible to fashion an X-Factor that will routinely include costs currently classified as exogenous and exclude costs that the Commission has determined are not exogenous."[55] The Commission asks additionally if it would be reasonable to limit exogenous cost treatment to jurisdictional cost shifts.

[55] Fourth FNPRM ¶ 139.

Not a single company among the commenting parties suggests that such an X-Factor can be fashioned. In fact, the consensus among all parties, with the exception of MCI, is that no changes need be made in the present rules. AT&T points out that sufficient safeguards exist within the present rules for all parties to have adequate input as to whether such changes are appropriate.[56]

Alone among all the commenting parties, MCI suggests that exogenous changes should be limited to jurisdictional changes required by the Commission.[57] Its rationale is that non-regulated companies must determine how to meet these other changes without being able to change their prices, and price cap regulation should mirror this supposed effect of the competitive market. MCI suggests that such changes are the result of business decisions. Contrary to MCI's opinion, competitive companies, free of regulation, do have the ability to move their prices up and down in response to changes in costs; the price cap LECs do not. Where MCI gets the idea that competitive companies are unable to change their prices is beyond rational thought. In fact, competitors in the interstate long distance market have raised prices within the past year, as just one example.[58] Gas stations, definitely a competitive marketplace, move their prices up and down on a continuing, sometimes seemingly random basis. MCI is merely continuing its policy of trying to eliminate any increase in access prices and to, in fact, push access prices down.

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[56] AT&T at 44-46.

[57] MCI at 25-26.

[58] See Dow Jones News, Feb. 16, 1996, "AT&T to Raise Basic Long-Distance Rates."

Based on the overall consensus of the industry (both LECs and their customers), existing rules for exogenous cost treatment should be left in place.

F. No Annual Performance Review Is Necessary

If the Capped Index Plan is adopted, no annual performance review is necessary. While PCIs will not decrease, the explosion of competition unleashed by the Telecommunications Act of 1996 will push prices down. Absent adoption of the Capped Index Plan, U S WEST recommends continuation of the Interim Price Cap Plan for one- or two-years until the results of the access reform docket and the dockets triggered by the Telecommunications Act of 1996 are resolved and some idea of their impact on the telecommunications marketplace can be assessed. A review at the end of that period would be appropriate. If the Commission opts for a TFP-based productivity adjustment, the plan should be reviewed no later than three years hence. Although U S WEST used a range of three to five years in its earlier comments, in light of the Act and the prospect of significant access reform, an earlier review will be required.

VII. CONCLUSION

In these Reply Comments, U S WEST urges the Commission to adopt its Capped Index Plan which would cap the PCIs at their current level while allowing the competition provided for in the recently passed Telecommunications Act of 1996 to dictate future pricing strategies.

Should the Commission forego the adoption of U S WEST's Capped Index Plan and its associated benefits, U S WEST alternatively supports the continued use of the Commission's Interim Price Cap Plan established by the First Report and Order for an additional year or two. In lieu of the aforementioned alternatives, U S WEST would recommend the Commission move forward with the USTA proposed Simplified TFP methodology. If the Simplified TFP methodology is implemented, U S WEST strongly recommends the adoption of two productivity factors tied to geographic density. The graphs provided herein demonstrate the disparate makeup of the various LECs subject to price caps. The use of two productivity factors, based on geographic density without the use of sharing options, would provide a fair and equitable system which recognized the relevant disparities of the various LECs. U S WEST has provided the Commission with choices which provide significant benefits in the form of reduced regulation and oversight. The Commission should choose to realize these benefits by adopting one of the proposals presented herein.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 1st day of March, 1996, I have caused a copy of the foregoing **REPLY OF U S WEST COMMUNICATIONS, INC.** to be served via first-class U.S. Mail, postage prepaid, upon the persons listed on the attached service list.

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